Fiscal responsibility & national debt: the Swiss model

The two "sister republics" (the United States and Switzerland) have in turn drawn inspiration from each other's constitutions. A mimicry that has no place when it comes to fiscal responsibility and indebtedness.

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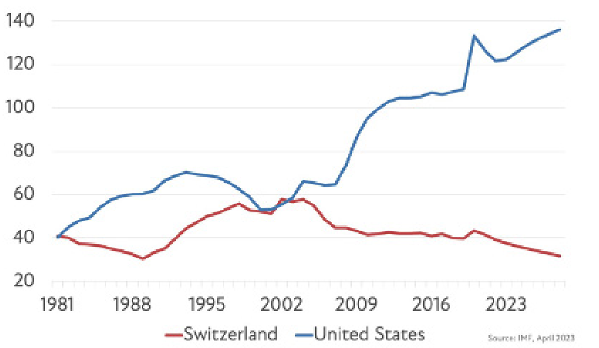
You may not know it, but Switzerland and the United States have often been referred to as "sister republics". Indeed, after the United States declared its independence in 1776, the founding fathers chose to base the American Constitution on the Swiss model of a confederation of sovereign states. Less than a century later, Switzerland in turn drew inspiration from the American Constitution when, in 1848, it adopted the Constitution that founded modern Switzerland, i.e. that of a federal state rather than a confederation of states.

But when it comes to public debt, the comparison stops there: over the last twenty years, the two sister republics have taken diametrically opposed paths, as the graph below shows.

Public debt of Switzerland (red line) and the United States (blue line) as a percentage of GDP



Source: IMF, Costa Vayenas

The Swiss positive austerity

In 2001, Article 126 of the Swiss Constitution codified a structural balanced budget rule for the federal government, known as the 'debt brake'. This was designed to prevent structural deficits leading to an increase in debt, as happened in Switzerland in the 1990s.

The provision was approved by popular vote (referendum) with an approval rate of 85% at the end of 2001. The new constitutional provision was applied for the first time to the 2003 federal budget.

The Swiss rule is relatively simple. The bulk of the federal budget must be planned to break even each year, after adjustment for economic conditions. In other words, "structural" borrowing is prohibited. Instead, the Swiss are content to cap federal spending each year at the level of structural tax revenues, i.e., adjusted for cyclical variations. As a result, public spending remains broadly stable around the trend in public revenues, rather than undergoing cycles of austerity and largesse.

When economic growth is below trend, budget deficits can occur. However, over the whole economic cycle, every Swiss franc of expenditure covered is paid for: surpluses must be generated in periods of expansion to compensate for borrowing when the economy is slowing down. In other words, it is a counter-cyclical fiscal policy.

Among the key principles of the budget rules:

1. The spending cap is linked to revenue estimates derived from past trends and short-term forecasts, not on long-term forecasts which are by their nature highly uncertain. This forces policymakers to raise taxes before permanently increasing spending. They cannot make allowances based on future 'room for manoeuvre' founded on over-optimistic projections.

2. Certain budgetary constraints can be relaxed during periods of recession and emergency. For example, spending that is useful during a downturn (e.g., unemployment insurance) is excluded from the spending ceiling. A six-year horizon has been granted to cover the accompanying measures linked to the Covid 19 pandemic. If borrowing has been higher than expected, the budget will be adjusted gradually. It is this flexibility that allows these budgetary rules to be compared to positive austerity.

3. Additional flexibility was built into the debt brake: it applies only to the federal budget. The cantons are able to establish their own rules to guarantee their financial health, and they do so responsibly.

The results are there for all to see. Since the introduction of this new constitutional provision, Swiss public debt as a percentage of GDP has fallen almost uninterruptedly. Despite the financial and the Covid-19 crises, the rule has stabilised gross public debt at around 40% of GDP. This ratio should even fall in the coming years.

Uncle Sam and the debt ceiling

Unlike Switzerland, the United States has never introduced a constitutional amendment aimed at establishing a balanced budget and curbing indebtedness. To make the federal government more fiscally responsible, it created the debt ceiling. Set by Congress, this ceiling is the maximum amount that the federal government can borrow to finance the obligations that elected officials and presidents have already approved.

The ceiling, which currently stands at $31.4 trillion, was created over a century ago. Since 1960, Congress has raised or extended the debt ceiling 78 times, including 29 times under Democratic presidents and 49 times under Republican presidents.

At the beginning of August, the rating agency Fitch downgraded the US Treasury's debt rating from AAA to AA+, corroborating what all the major federal budget and monetary agencies have been saying for years: the country is on an imprudent and unsustainable fiscal path, and nothing has been done to remedy it. The figures speak for themselves: since fiscal year 2000, the debt subject to the ceiling has risen from around $5.7 trillion to around $32.5 trillion today. Total federal liabilities and unfunded social insurance obligations have risen from around $20 trillion in fiscal year 2000 to around $125 trillion today. Over the same period, the ratio of total public debt to GDP has risen from around 55% to around 120%. The Congressional Budget Office (CBO) predicts that it will reach about 181%

of GDP by 2053 and that it will continue to rise under current legislation. What's more, the fastest-growing federal expense is interest on the debt: interest charges have risen by around 50% over the past year, to almost $1,000 billion on an annual basis.

While the United States has never had trouble finding investors to finance this gigantic debt, the situation is now becoming more complicated. The amounts of US treasury bonds held by the Chinese and Saudis are falling steadily. This is a paradigm shift, and the geopolitical situation has a lot to do with it. On the other hand, Japanese investors (who are the main holders of US debt) could also start to shun US debt at a time when yields on Japanese bonds are rising following the Bank of Japan's change of monetary policy.

The Japanese experience

Despite the aforementioned risks, it seems impossible to envisage the United States defaulting on its debt at all. There is a simple reason for this: a government can never default on its local currency debt if its central bank is prepared to buy the bonds. This is the case not only for Uncle Sam but also for Japan.

The Japanese case is also instructive, particularly in terms of the hidden risks incurred by investors in government bonds. Indeed, one consequence of a central bank buying unlimited quantities of domestic sovereign bonds is that, at some point, the private sector no longer wants this paper. For example, the Bank of Japan now owns more than half of the Japanese government bond market, which has the effect of making this market relatively illiquid.

Another consequence of a central bank buying generous amounts of government paper is that these purchases are generally made by printing more fiat money. The result is either inflation or currency depreciation, or both.

The chart below shows that the Japanese yen has lost more than half its value against the Swiss franc since the turn of the century. This depreciation makes investing in Japanese bonds totally inadvisable for an investor whose reference currency is the Swiss franc. Indeed, even if Japanese government bonds have never run the risk of default, their illiquidity and the chronic depreciation of the yen against the Swiss franc make Japanese bonds an unadvisable investment vehicle.

Source: IMF, Costa Vayenas

The same reasoning applies to the US bond market. Despite the generous yield differential between Treasury bonds and Swiss government bonds, Swiss investors must take into account the risks of inflation and currency depreciation incurred by the United States.

A Swiss model for the world?

As Daniel Müller-Jentsch of Avenir Suisse put it: "Switzerland has drawn up the blueprint for what I am sure will be the standard tax model of the future".

Although the debt brake is already part of the policies of many governments in the form of fiscal rules using predefined ratios (e.g., the EU's stability pact), these mechanisms have not always been respected due to occasional economic threats, resulting in a sharp rise in public debt in many developed economies. Rapidly ageing populations and rising social protection costs linked to unemployment and health insurance threaten to add a further debt burden in most of these countries. For many states, the temptation is great to turn to the central bank and commercial banks for help in financing their growing debt. As we saw above with the Japanese case, these lax policies are not sustainable in the long term and will one day force these countries to return to budgetary discipline.

In this context, Switzerland's positive austerity could well serve as a model. It teaches us that two measures are essential to restore the health and viability of a nation's public finances.

First, the introduction of a constitutional amendment on fiscal responsibility. The debt ceiling and other approaches designed to limit federal spending and prevent an increase in the debt burden have failed to achieve their objectives. The only way to bind both current and future legislative powers is through a constitutional amendment. This is what was put in place in Switzerland.

Secondly, the setting up of a non-partisan Commission whose mission would be to formulate a set of budgetary, expenditure and revenue recommendations aimed at reducing public debt/GDP to a given level by a given year. To be effective, this Commission must be made up of competent, credible and non-conflicting individuals from different political affiliations. The Commission will also have to educate and involve the people. And this is perhaps where the greatest difficulty lies. Direct democracy is part of Switzerland's success story of positive austerity. Remember: it was approved by 85% in a referendum. Will the same be true for other nations?

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